STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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May 16, 2003

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STEVE WESTLY
State Controller, Sacramento

JAMES E. SPEED
Executive Director

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the May 28, 2003 Business Taxes Committee meeting. This meeting will address the proposed revisions to Chapter 4, *General Audit Procedures*, of the Board's Audit Manual.

Action 1 on the agenda concerns proposed revisions regarding the tax application of tangible personal property purchased for resale when the property is moved from an inventory account to a fixed asset account and depreciated.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Board Meetings and Committee Information" page on the Board's Internet web site (http://www.boe.ca.gov/meetings/meetings.htm#two) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **May 28, 2003** in Room 121 at the address shown above.

Sincerely,

Ramon J. Hirsig
Deputy Director
Sales and Use Tax Department

RJH: lk

Enclosures

cc: (all with enclosures)
Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice Chairman
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable John Chiang, Member, Fourth District
Honorable Steve Westly, State Controller

Ms. Carole Ruwart, Board Member's Office, First District (MIC 71)
Ms. Sabina Crocette, Board Member's Office, First District (via e-mail)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)
Mr. Matthew Zylowski, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Second District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (MIC 78)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78)
Mr. John Thiella, Board Member's Office, Fourth District (MIC 72)
Ms. Marcy Jo Mandel, State Controller's Office
Mr. Timothy Boyer (MIC 73)
Ms. Jean Ogrod (MIC 83)
Mr. David Gau (MIC 63)
Ms. Janice Thurston (MIC 82)
Mr. Warren Astleford (MIC 82)
Mr. Robert Lambert (MIC 82)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (via e-mail)
Mr. Rey Obligacion (via e-mail)
Ms. Jennifer Willis (MIC 70)
Mr. Dan Tokutomi (via e-mail)
Mr. Dave Hayes (MIC 67)
Ms. Charlotte Paliani (MIC 92)
Mr. Joseph Young (via e-mail)
Mr. Jerry Cornelius (via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Jeffrey L. McGuire (via e-mail)
Mr. Vic Anderson (MIC 40 and via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Laureen Simpson (MIC 50)
Ms. Barbara McCrory (via e-mail)
Mr. Lou Feletto (via e-mail)
Ms. Leila Khabbaz (MIC 50)
Mr. Todd MacMurray (MIC 50)
District Principal Auditors (via e-mail)

AGENDA — May 28, 2003 Business Taxes Committee Meeting

Proposed Revisions to Audit Manual Chapter 4, General Audit Procedures, Regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

Action 1 — Capitalization and Depreciation of Property Used for Demonstration and Display Audit Manual Chapter 4, Section 0408.28. Agenda, page 2.	Adopt either: Staff's recommendation to clarify that tax applies to the cost of extax resale property otherwise used for demonstration and display when such property is moved from a resale inventory account to a capital asset account and depreciated for income tax purposes, because the property is no longer regarded as being held for sale in the regular course of business. OR Interested parties' recommendation to clarify that, if a taxpayer can provide evidence that property is used solely for demonstration and display, there is no taxable use of the property, and expensing or capitalizing and depreciating the property, by itself, should not trigger the use tax.
Action 2 – Approval to Publish	Recommend publication of amendments to Audit Manual Chapter 4 as adopted in the above action. Operative Date: None Implementation: Upon Board approval

AGENDA — May 28, 2003 Business Taxes Committee Meeting

Proposed Revisions to Audit Manual Chapter 4, General Audit Procedures, Regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

Action Item	Language Proposed by Staff	Language Proposed by Ernst & Young and PricewaterhouseCoopers
Action 1 - **Tax application of property purchased for resale and moved from an inventory account to a fixed asset account and depreciated.**	**CAPITALIZATION OF RESALE INVENTORY 0408.28** Resale merchandise that is withdrawn from resale inventory, including property used for demonstration and display, capitalized in a fixed asset account and depreciated for income tax purposes is not held for sale in the regular course of business and should be included in the schedule of unreported property subject to tax.	**CAPITALIZATION OF RESALE INVENTORY 0408.28** Resale merchandise that is withdrawn from resale inventory, capitalized in a fixed asset account and depreciated for financial accounting purposes, is generally regarded as not held for sale in the regular course of business. If resale inventory is capitalized and not reported as a purchase subject to use tax, the amounts should be scheduled and included in the measure subject to tax unless the taxpayer can establish that the item in question was used exclusively in an exempt manner, such as demonstration and display. Auditors should exercise their good judgment in auditing these types of inventory transfers. Each situation will present a unique set of facts and circumstances, which will have to be evaluated to reach a reasonable conclusion. As in other areas examined in an audit, sampling will generally be a useful tool that can be utilized. The following evidence illustrates the types of information, which may be available to establish that capitalized equipment was used in an exempt manner, such as demonstration and display: • The taxpayer can trace the inventory transfer to a purchase requisition that discloses the name of the customer who will be evaluating the equipment.

AGENDA — May 28, 2003 Business Taxes Committee Meeting

Proposed Revisions to Audit Manual Chapter 4, General Audit Procedures, Regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

Action Item	Language Proposed by Staff	Language Proposed by Ernst & Young and PricewaterhouseCoopers
		• The customer signs a loan demonstrator agreement, which provides an audit trail to the inventory withdrawal. • The taxpayer uses a third party to manage and track demonstration equipment held by customers and business partners. Records of the third party can establish where the assets are located and their use. • The taxpayer's capital equipment records have sufficient detail to trace the life of the asset and one can reasonably determine how the asset was used, by looking at the detailed record.

Document1 rev. 3-26-01

Issue Paper Number **03-004**

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

Proposed Revisions to Audit Manual Chapter 4, *General Audit Procedures*, Regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

I. Issue

Should Audit Manual (AM) Chapter 4 be revised to make clear that when resale inventory, including property used for demonstration and display, is moved from an inventory account to a capital account and depreciated, that property is not regarded as held for sale in the regular course of business and tax must be paid measured by the purchase price of the property?

II. Staff Recommendation

Staff recommends that AM Chapter 4 be revised to clarify that tax applies to extax property (property purchased without the payment of tax) otherwise used for demonstration and display when such property is moved from an inventory account to a capital account and depreciated for income tax purposes. When that occurs, the property is no longer held for sale in the regular course of business as required in Revenue and Taxation Code (RTC) sections 6094 and 6244. See Issue Paper (IP) pages 3-6, and agenda action item 1. A comparison of staff's and interested parties' proposed language is attached as Exhibit 2.

III. Other Alternative(s) Considered

Mr. Glenn Bystrom of Ernst and Young (E&Y), supported by Messrs. William Lasher and Dennis Fox of PricewaterhouseCoopers (PWC), recommends that AM Chapter 4 be revised to provide that, if a taxpayer can provide evidence that property is used solely for demonstration and display, there is no taxable use of the property and, expensing or capitalizing and depreciating the property by itself should not trigger the use tax. See Issue Paper (IP) pages 6-9, and agenda action item 1. A comparison of staff's and interested parties' proposed language is attached as Exhibit 2.

IV. Background

At the request of the Business Taxes Committee Chair for July-December 2002, this topic was scheduled for the Business Taxes Committee (BTC) agenda to allow the participation of interested parties in the review of proposed revisions to Audit Manual Chapter 4. The purpose of the proposed revisions is to seek Board clarification regarding the application of tax to property otherwise used for demonstration and display, purchased for resale without the payment of tax, when such property is moved from resale inventory into a fixed asset account and depreciated. This topic had been discussed in previous correspondence between staff and interested parties since 1999, attached as Exhibit 3, and the proposed revisions are sought to resolve confusion or inconsistencies in this area of law.

RTC section 6201 imposes a tax on the sales price of tangible personal property purchased from any retailer for the storage, use, or other consumption of the property in this state. Section 6009 explains that "use" includes the exercise of any right or power over tangible personal property incident to the ownership of that property, except that it does not include the sale of that property in the regular course of business. Sections 6094 and 6244 provide that if a purchaser who gives a resale certificate makes any use of the property other than retention, demonstration, or display **while holding it for sale in the regular course of business** (emphasis added), the purchaser is liable for use tax on the purchase of the property.

Subdivision (a) of Regulation 1669, *Demonstration, Display, and Use of Property Held for Resale – General*, provides:

> "A purchaser of tangible personal property who gives a resale certificate therefor, and who uses the property solely for demonstration or display while holding it for sale in the regular course of business, is not required to pay tax on account of such use. Except as otherwise provided in this regulation, if the property is used for any purpose other than or in addition to demonstration or display, such as making deliveries, personal use of employees, etc., the purchaser must include in the measure of the tax paid the purchase price of the property. Tax applies to the subsequent retail sale of the property."

Subdivisions (a)(3) and (a)(7) of Regulation 1669.5, *Demonstration, Display, and Use of Property Held for Resale – Vehicles* provide:

> "Demonstration or Display. A purchaser of a vehicle under a resale certificate, who uses the vehicle solely for demonstration or display while holding it for sale in the regular course of business, is not required to pay tax on account of such use."

> "Vehicles Capitalized as Fixed Assets. Except for vehicles held for the purpose of leasing, vehicles which are capitalized in a fixed asset account and depreciated for income tax purposes are not held for sale in the regular course of business. Tax must be paid measured by the purchase price of such vehicles."

In *McConville v. State Bd. of Equalization* (1978) 85 Cal.App.3d 156 (*McConville*), the court concluded that a taxpayer's capitalization and depreciation of property for state and federal income tax purposes supported a finding that the property was not resale inventory held for demonstration and display, but instead was property used as a capital asset and therefore subject to use tax. The court further found that resale inventory is not ordinarily subject to a depreciation allowance as a capital asset for income tax purposes.

Staff held meetings with interested parties on February 4, 2003 and March 11, 2003. Subsequent to the meetings, E&Y and PWC submitted their recommendation, analysis and comments. This matter is scheduled for discussion at the May 28, 2003, meeting of the Board's Business Taxes Committee (BTC).

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends that AM Chapter 4 be revised to clarify that tax applies to extax property (property purchased without the payment of tax) otherwise used for demonstration and display when such property is moved from an inventory account to a capital account and depreciated for income tax purposes. When that occurs, the property is no longer held for sale in the regular course of business as required in Revenue and Taxation Code (RTC) sections 6094 and 6244.

This position is based on the specific requirement in sections 6094 and 6244 that property used in demonstration and display be held for sale in the regular course of business. The question is how the statutory phrase "while holding it in the regular course of business" should be interpreted, or whether the phrase should be entirely ignored While Sales and Use Tax statutes define "sale," "purchase," and "use," they do not specifically define "held for sale in the regular course of business." Sales and Use Tax Regulation 1669.5(a)(7) does, however, explain when certain property is not held for sale in the regular course of business. As stated above, Regulation 1669.5(a)(7) provides that "*Except for vehicles held for the purpose of leasing, vehicles which are capitalized in a fixed asset account and depreciated for income tax purposes are not held for sale in the regular course of business. Tax must be paid measured by the purchase price of such vehicles.*" Staff believes the rationale of Regulation 1669.5(a)(7) is applicable to the demonstration and display use of all tangible personal property and its recommendation is consistent with this application of law.

Staff notes that inventories are asset items held for sale in the ordinary course of business and exclude assets subject to depreciation. (See Kieso, et al., *Intermediate Accounting*, 10th ed., vol. 1 (2001) p. 394; see also Treas. Regs § 1.471-1; 2002 *Federal Tax Handbook* (RIA 2001) § 2866; *2001 Miller GAAP Guide*, Harcourt Inc. 2001, pp 12.04, 27.04.) Fixed assets, on the other hand, are used in production, distribution, and services by all enterprises. They are held primarily for use, not for sale. The classification of an item in the books of record as either an inventory item for resale in the ordinary course of business or as a fixed asset subject to depreciation must be viewed as a consistent representation of the business purpose of the item. In administering the Sales and Use Tax Program, the Board reviews the books and records maintained by taxpayers and assumes that book entries classifying property as inventory or fixed assets for financial reporting and income tax purposes reflect the underlying use of the property. The taxpayer's representation, as disclosed in the financial statements and income tax returns, is not only relied upon by the Board for auditing purposes, but also by shareholders, managers, lenders, suppliers, employees, customers, financial analysts, the general public and other regulatory authorities. Since a taxpayer's income tax returns are signed under penalty of perjury as to their accuracy, it is reasonable for staff to rely on these returns and to furthermore conclude that capitalized and depreciated property is held for use in trade or business, not for sale in the regular course of business.

Contrary to the interested parties' assertions, staff's position is not based on the mere 'accounting treatment' of the property. Staff agrees that property held in inventory may be written down (i.e., expensed) to the lower of cost or market to reflect events such as obsolescence, price level changes, or damage to inventory. However, when a taxpayer transfers extax property from an inventory account to a capital asset account, that transfer is a concession by the taxpayer that the property is no longer held for sale and that the property will instead be used indefinitely in the trade or business. The act of expensing some portion of inventory merely reflects a change in value of that inventory and does not change the character of the property itself. Conversely, the capitalization of extax inventory does represent a change in the character and nature of the property from that of inventory held for resale to that of an asset not held for sale and instead used in a business operation or for the production of income. Staff further believes that once property is capitalized and depreciated, it is administratively difficult to differentiate which 'use' constitutes demonstration and display while holding it for sale in the regular course of business and which 'use' does not. If the information disclosed for financial and income tax purposes becomes insignificant for sales and use tax purposes, the accuracy of sales and use tax reporting becomes questionable. Staff also believes that the provisions of RTC sections 6094 and 6244 require that a clear standard must be set for determining when property is or is not held for sale in the regular course of business. In the absence of such a standard, the mere fact that the property is demonstrated would be the only criterion for avoiding tax, even if such property is never held for sale in the regular course of business.

Internal Revenue Code (IRC) section 167 provides for the depreciation of property "used in the trade or business" or "held in the production of income." Staff interprets these provisions to mean that when extax property is moved from an inventory account to a capital account for purposes of depreciation, that property is used in a business or for the production of income and is no longer held for sale in the regular course of business. Treasury Regulation section 1.167(a)-2 specifically provides that "inventories and stock in trade" may not be depreciated. Internal Revenue Code section 1221(a) defines the term "capital asset" to exclude stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Extax property not held for sale in the regular course of business is subject to tax based on its storage, use, or consumption inside this state.

Staff's research of financial and income tax authorities has disclosed that the capitalization and depreciation of an asset is incompatible with the assertion that such asset is held for sale in the regular course of business. IRS Publications 911 and 946 state the following in regard to inventory and demonstrators:

> "**Inventory.** You never can depreciate inventory because it is not held for use in your business. Inventory is any property you hold primarily for sale to customers in the ordinary course of your business. In some cases, it is not clear whether property is held for sale (inventory) or for use in your business. If it is unclear, examine carefully all the facts in the operation of the particular business."
>
> "**Demonstrators.** If you keep your company's products on hand to show to potential customers, their cost may be part of the cost of goods sold, a capital expense, a business expense, or a personal expense, depending on the circumstances. If you use a demonstrator for more than one year, its cost is a capital expense. **However, if you expect to eventually sell the demonstrator, include it in your inventory of goods for sale."** (Emphasis added).

In addition, in the leading case of *Duval Motor Company v. Commissioner of Internal Revenue* (5th Cir., 1959) 264 F.2d 548, an automobile dealer tried to take a depreciation deduction for company cars that were temporarily assigned to use in the dealership business for display or demonstration purposes. The appellate court, however, held that such vehicles could not be depreciated, reasoning that mere temporary use for display and demonstration purposes did not alter their status as stock in trade. In other words, the court held that an asset may not be taken from inventory and placed into a depreciable asset account merely because it is temporarily used for demonstration and display purposes. The Internal Revenue Service's Revenue Ruling 75-538, 1975-2C.B.34, is to the same effect, stating that "A vehicle is not property used in the business if it is merely used for demonstration purposes, or temporarily withdrawn from stock-in-trade or inventory for business use." Other income tax cases are consistent with *Duval*, and the Internal Revenue Service's Revenue Ruling 89-25, 1989-1 C.B. 79, applies *Duval*'s holding to model houses and houses used as sales offices during the marketing of newly constructed residential subdivisions. Based upon these authorities, when a Board sales and use tax auditor encounters an asset which normally would be stock in trade, but instead has been placed in a depreciable asset account for income tax purposes, the only inference that the auditor logically may draw is that the asset has been withdrawn from inventory and committed to use in the trade or business.

E&Y provided Financial Accounting Standards Board (FASB) Statement 13, *Leases*, as its authority that inventory may be depreciated. E&Y believes that since rental inventory may be leased on an extax basis and must also be depreciated for income tax purposes, property used for demonstration and display that is capitalized and depreciated may also be retained as extax property held for sale in the regular course of business. For more details regarding E&Y and PWC's analysis, see Section VI. Staff notes, however, that leased property is not inventory held for sale in the regular course of business. Lessors own the property and use that property for the production of income. In that regard, a lease of tangible personal property is subject to tax measured by the rentals payable unless the property is leased in substantially the same form and the lessor timely paid tax measured by the purchase price of the property. In other words, leased property is subject to tax – either measured by the purchase price of the property or by rentals payable – since that property is not held for sale in the regular course of business. The fact that a lessor may elect to report and pay tax pursuant to two different methods does not mean that the leased property is held for sale in the regular course of business.

Staff also disagrees with E&Y and PWC's contention that their recommendation is limited to a small section of the electronics industry or that only two taxpayers capitalize property held for resale. Results of staff inquiry into audit and appeals cases indicate this issue affects many industries, such as medical, scientific, testing, and other manufacturing equipment and machinery, automotive accessories, etc.

B. Pros of the Staff Recommendation

- Is consistent with the application of tax to capitalized inventory in Regulation 1669.5.
- Provides clear guidance to taxpayers and staff regarding the treatment of property moved to a fixed asset account and depreciated.

C. Cons of the Staff Recommendation

Does not address the concerns expressed by E&Y and PWC regarding the handling of property used for demonstration and display by certain electronics firms.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will need to update Audit Manual Chapter 4 and distribute it to holders of the Audit Manual. The workload associated with revising and distributing pertinent sections of Audit Manual Chapter 4 is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

The staff recommendation has no revenue impact. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Advice to taxpayers through responses to inquiries and audit findings will be more consistent.

H. Critical Time Frames

None. Revisions will take place upon Board approval.

VI. Alternative 1

A. Description of the Alternative

Revise Audit Manual Chapter 4 to provide that property transferred from a resale inventory account to a capital asset account and depreciated is an indication of intent to use the property and is generally subject to tax. However, if a taxpayer has evidence that capitalized and depreciated property was used solely for demonstration and display while holding the property for sale in the regular course of business, there is no taxable use of the property and the accounting treatment, by itself, should not trigger a use tax. The following paragraphs embody analysis and comments submitted by E&Y and PWC in the last year in support of their position.

E&Y asserts that the Board allows retailers to dedicate a portion of their inventory to be used exclusively for demonstration and display and not actually offer that property for sale until its use in demonstration and display has ended, without incurring a tax liability. See Annotation 210.0160 (6/29/56). They then conclude that, as long as a taxpayer can establish that a property was used exclusively for demonstration and display, the accounting treatment, by itself, should not have a sales and use tax consequence. E&Y further believes that there is little economic difference between depreciation of extax inventory moved to a capital account and the expensing of inventory to the lower of cost or market value in order to reflect a reduction in value to that inventory.

Court Decisions

E&Y does not dispute the *McConville* holding that the taking of depreciation should be considered as an indication of use. However, they believe that the *McConville* decision was influenced by the taxpayer's extremely high percentage of inventory that was depreciated over a period of years. Under a more typical fact pattern, particularly in the computer industry, E&Y indicates that only a very small portion of the inventory is used for demonstration and display and, in their view, *McConville* does not apply.

E&Y and PWC maintain that the *McConville* decision provides that the taking of depreciation should be an indication of use and that the facts and circumstances of the case do not reflect the fact pattern for typical manufacturers like their clients. In *McConville*, the taxpayer classified the majority of their horses as demonstration and display while a typical manufacturer will hold only a very small fraction of its resale inventory in demonstration and display status. As a result, E&Y and PWC assert that the taking of depreciation should not be the decisive factor for determining the existence of a taxable use.

E&Y and PWC also believe the Board should look beyond the accounting and tax treatment of demonstrated equipment. They believe the Board should instead look to the true object of the transaction and that, in determining whether a purchase is a taxable use or a sale for resale, the courts and the Board have consistently examined the primary purpose of the purchase. E&Y and PWC maintain the Board has consistently disregarded the accounting treatment and applied the primary purpose test to raw material inventories in the manufacturing environment.

Although *Navistar v. State Board of Equalization* (1993) 13 Cal.App.4th 1459 (*Navistar*) was superseded by the California Supreme Court, E&Y argues that the Supreme Court ruling upheld the language and the principles described by the lower Appellate Court case. They quote language from the superseded *Navistar* Court of Appeal decision as support for their position. This language, however, is uncitable pursuant to California Rules of Court, Rules 976 and 977.

Specific Interest of E&Y and PWC

E&Y and PWC explain that they represent major computer manufacturers that use some of their products exclusively as demonstrators for up to 18 months. Customarily, their clients' customers will use a demonstrator computer for up to 90 days. E&Y and PWC's clients generally use a third party to manage and track demonstration equipment held by customers. E&Y and PWC maintain that their clients capitalize their computers and depreciate them to reflect the reduction in value, and that there is little economic difference between the taking of depreciation and writing the inventory down to the lower of cost or market value. E&Y and PWC state that if the manufacturer had placed the same computers into a "Demonstration Inventory" account, the Board would take the position that tax does not apply to the use of the computers as demonstrators. E&Y and PWC nevertheless state that their clients wish to capitalize and depreciate this property as a capital asset rather than write down their demonstration computers in an inventory account to the lower of cost or market.

E&Y and PWC explain that the manufacturer is capable of tracking the location of each individual asset that is loaned to a customer through the automated inventory capital asset transfer system. They assert that this powerful asset tracking ability is the primary business purpose behind the manufacturer deciding to capitalize its demonstration and display inventory, not to identify this small population of demonstration equipment as capital assets for income tax purposes. They believe that in capitalizing demonstrators, the manufacturer chooses the most cost efficient, convenient and conservative approach for handling transactions they assert are immaterial to their clients' financial statements. PWC provided a sample "Equipment Loan-Demonstration Agreement" which provides

that the manufacturer makes available loaned computer hardware and software to customers on a temporary, no-charge basis. The agreement lists the quantity, unit type and a brief description of the equipment loaned. It authorizes the customer to use the loaned equipment for a specified period of time at a specified location for internal business and evaluation purposes. The manufacturer retains title to all software and a security interest in all loaned equipment. The customer is required to carry property insurance to cover the replacement cost of the loaned equipment and is responsible for paying all taxes imposed as a result of equipment use or possession. At the termination of the agreement, the customer is responsible to pack and ship the equipment to the designated third party.

PWC states that situations requiring capitalization and depreciation of demonstration equipment are rare and limited to some sectors of the electronics industry. In fact, they know of only two clients where this occurs. During the period of loaning the demonstration units to customers, significant technology obsolescence along with wear and tear occurs. Upon return of the demonstration units, their value is a small fraction of a newly manufactured product.

Accounting Authority

In its April 7, 2003 submission, E&Y reiterated their contention that their proposal conforms to Regulation 1669 and that staff is placing undue emphasis on the accounting and income tax rules at the expense of conformity to sales and use tax regulations. In response to staff's request to provide authority for the depreciation of inventory held in the regular course of business, E&Y cites FASB 13, which provides that the cost of the property leased to the lessee in an operating lease is included in the lessor's balance sheet as property, plant, and equipment. It also provides that the lessor's income statement will normally include the expenses of the leased property such as depreciation. E&Y then makes a connection between FASB 13's requirement to capitalize and depreciate the property and Sales and Use Tax Regulation 1660's definition of "lease" as a "continuing sale by the lessor" and a "continuing purchase by the lessee." They conclude that property leased pursuant to an operating lease qualifies as inventory held for resale. E&Y prepared a flow chart comparing what they view as the physical movement of property in a typical equipment lease and the typical loan of demonstration and display property. E&Y concludes that the two transactions are identical and the sales and use tax treatment should also be identical, based on the following stated characteristics:

1. Property is withdrawn from extax inventory,
2. Property is capitalized and depreciated,
3. Inventory is idle when not in use,
4. Property is loaned or rented to a customer,
5. The taxability is determined by the customer use,
6. If taxable, sales tax may be computed at fair rental value,
7. When customer returns property, it is placed back in idle inventory, and
8. Property enters into a new lease or loan agreement or is sold to a customer.

Use of income tax rule as a definitive test

PWC states that a cross reference to the Income Tax Code is not necessary or advisable in this case due to what they believe to be the difference in the definition of "held for sale" for income tax and for sales and use tax purposes. PWC asserts that pursuant to Internal Revenue Service rules, if property is primarily held for sale, it generally cannot be depreciated. If property is primarily used in the course of business, it can be depreciated. If inventory held for sale is temporarily used for another purpose, it cannot be depreciated. For sales and use tax purposes, generally any use other than demonstration and display constitutes a taxable use of the property.

Administrative issue

In response to staff 's opinion that Alternative 1 would undermine the proper administration of the sales and use tax program in this area, E&Y states that the audit staff does not primarily rely on financial or income tax filing to substantiate the accuracy of the sales and use tax reported. They verify the accuracy of sales and use tax reporting by employing detailed testing and other auditing procedures of the taxpayer's source documents.

In addition, E&Y and PWC note that the audit staff has allowed property used for exempt demonstration and display purposes in prior audits of some taxpayers irrespective of the accounting treatment.

Potential revenue impact

In their most recent submissions, both E&Y and PWC believe this alternative will have minimal revenue impact because, in their view, a very limited number of taxpayers currently capitalize demonstrated property and because they believe taxpayers always have the option not to capitalize qualified demonstration and display property in future periods. PWC also claims that since revenue implications involving property used for demonstration was considered by the legislature when they enacted RTC sections 6094 and 6244, their alternative would not result in additional revenue losses to the state.

B. Pros of the Alternative

It allows, under specified conditions, extax inventory that is moved to a capital account and depreciated to not be subject to use tax.

C. Cons of the Alternative

The proposed language raises the following concerns:

- It limits the nontaxable status to a limited number of companies who contract with a third party asset management company. There is no basis in the law for such limitation.
- It fails to require taxpayers to provide records showing the disposition of the property after it is depreciated.
- In regard to the use of sampling as a tool in audits, it could mislead taxpayers into believing that they are only required to maintain a sample of the records showing how the property was used. However, valid sampling techniques require that supporting records be available for the entire population being sampled.

D. Statutory or Regulatory Change

No statutory or regulatory changes are required.

E. Administrative Impact

This alternative is expected to generate claims for refund of taxes previously reported or assessed on demonstration and display property that has been capitalized and depreciated. At least one such claim is being held in the appeals process pending resolution of this issue.

F. Fiscal Impact

1. Cost Impact

There will be no additional costs. Staff will need to update Audit Manual Chapter 4 and distribute it to holders of the Audit Manual. The workload associated with revising and distributing pertinent sections of Audit Manual Chapter 4 is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

The revenue loss from this proposal is estimated to be $31.3 million per year. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Advice to taxpayers through responses to inquiries and audit findings will be more consistent.

H. Critical Time Frames

None. Implementation will take place upon Board approval of the revisions.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: May 13, 2003

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

BOARD OF EQUALIZATION
REVENUE ESTIMATE

Proposed Revision to Audit Manual Chapter 4, *General Procedures,* Regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated, *IPN 03-004*

Recommendation and Alternatives

Staff Recommendation:

Staff recommends that Audit Manual Chapter 4 (AM Ch 4) be revised to clarify that tax applies to extax property (property purchased without the payment of tax) otherwise used for demonstration and display when such property is moved from an inventory account to a capital account and depreciated for income tax purposes. When that occurs, the property is no longer held for sale in the regular course of business as required in Revenue and Taxation Code (RTC) sections 6094 and 6244.

Alternative 1:

Mr. Glenn Bystrom of Ernst and Young (E&Y), supported by Messrs. William Lasher and Dennis Fox of PricewaterhouseCoopers (PWC), recommend that AM Ch 4 be revised to provide that, if a taxpayer can provide evidence that property is used solely for demonstration and display, there is no taxable use of the property and, expensing or capitalizing and depreciating the property by itself should not trigger the use tax.

Background, Methodology, and Assumptions

Staff Recommendation:

There is nothing in the staff proposed revision to Audit Manual Chapter 4 that would impact revenues.

Alternative 1:

.

Alternative 1 would impact revenues. Currently, extax property transferred from an inventory account to a capital asset account is subject to the use tax. Alternative 1 would provide that some of this property would not be subject to the use tax.

We do not know the extent to which property is currently being transferred from an extax inventory account to a capital asset account and then used for demonstration and display. In addition, we have no way of predicting how many businesses will adjust their operations in relation to this change.

An analysis of recent audits and discussions with the Board's audit staff indicates that this issue affects many industries, such as medical, scientific, testing, and other manufacturing equipment and machinery.

As an estimate of the order of magnitude of the revenue impact, we gathered information on the value of inventories of certain manufactured durable goods. The US Census Bureau reports that the total value of inventories for industrial machinery, construction machinery, metalworking machinery, computers and electronic products, medical, scientific, testing, photographic, audio, video, measuring, and electrical equipment amounts to $65.5 billion annually in the United States. Based on the size of California's economy, we estimate that seasonally adjusted value of inventory in California is $7.9 billion (12% x $65.5 billion). If 5% of this amount is transferred from an extax inventory account to a capital asset account, the value of this property would amount to $395 million ($7.9 billion x 5%). The revenue loss from exempting this capitalized property from state and local sales and use tax equals $31.3 million annually ($395 million x .0792, state and local tax rate).

Revenue Summary

The staff recommendation has no revenue effect.

As an estimate of the order of magnitude for alternative 1, if 5% of the value of certain manufactured durable goods inventory held for sale in California, as noted above, was transferred from an extax inventory account to a capital asset account and then used for demonstration and display, as reported by the taxpayer, this proposal could have an annual revenue impact of $31.3 million, as follows:

	Revenue
State (5%)	$19.8 million
Local (2.25%)	8.9 million
Special District (.67 %)	2.6 million
Total	$31.3 million

The effect of alternative 1 would be retroactive and would create a potential for refunds for 3 years.

Preparation

Bill Benson, Jr, Research and Statistics Section, Legislative Division prepared this revenue estimate. This revenue estimate was reviewed by Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department, and by Mr. Dave Hayes, Research and Statistics Section Manager, Legislative Division. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of April 30, 2003.

Proposed Revisions to Audit Manual Chapter 4, *General Audit Procedures*, regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

Comparison of Staff's and Interested Parties' Proposed Language

Current as of April 22, 2003

Action Item	Current Language	Language Proposed by Staff	Language Proposed by E&Y and PWC	Summary Comments
ACTION 1 — Capitalization and depreciation of property used for demonstration and display	None	**CAPITALIZATION OF RESALE INVENTORY 0408.28** Resale merchandise that is withdrawn from resale inventory, including property used for demonstration and display, capitalized in a fixed asset account and depreciated for income tax purposes is not held for sale in the regular course of business and should be included in the schedule of unreported property subject to tax.	**CAPITALIZATION OF RESALE INVENTORY 0408.28** Resale merchandise that is withdrawn from resale inventory, capitalized in a fixed asset account and depreciated for financial accounting purposes, is generally regarded as not held for sale in the regular course of business. If resale inventory is capitalized and not reported as a purchase subject to use tax, the amounts should be scheduled and included in the measure subject to tax unless the taxpayer can establish that the item in question was used exclusively in an exempt manner, such as demonstration and display. Auditors should exercise their good judgment in auditing these types of inventory transfers. Each situation will present a unique set of facts and circumstances, which will have to be evaluated to reach a reasonable conclusion. As in other areas examined in an audit, sampling will generally be a useful tool that can be utilized. The following evidence illustrates the types of information, which may be available to establish that capitalized equipment was used in an exempt manner, such as demonstration and display:	Staff's proposed language clarifies that tax applies to property used for demonstration and display when such property is moved from an inventory account to a capital account and depreciated. Interested parties' proposed language provides that tax does not apply to property used for demonstration and display whether or not the property is capitalized and depreciated.

Proposed Revisions to Audit Manual Chapter 4, *General Audit Procedures*, regarding Property Held for Resale, when the Property is Transferred from an Inventory Account to a Capital Asset Account and Depreciated

Comparison of Staff's and Interested Parties' Proposed Language

Current as of April 22, 2003

Action Item	Current Language	Language Proposed by Staff	Language Proposed by E&Y and PWC	Summary Comments
			• The taxpayer can trace the inventory transfer to a purchase requisition that discloses the name of the customer who will be evaluating the equipment. • The customer signs a loan demonstrator agreement, which provides an audit trail to the inventory withdrawal. • The taxpayer uses a third party to manage and track demonstration equipment held by customers and business partners. Records of the third party can establish where the assets are located and their use. • The taxpayer's capital equipment records have sufficient detail to trace the life of the asset and one can reasonably determine how the asset was used, by looking at the detailed record.	

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State Controller, Sacramento

JAMES E. SPEED
Executive Director

July 29, 2002

Mr. Glenn Bystrom
Ernst & Young
725 South Figueroa Street
Los Angeles, California 90017-5418

Re: Unidentified Taxpayer;
Transfer of Property from Inventory to Asset Account

Dear Mr. Bystrom:

This is in response to your May 13, 2002 letter to Supervising Tax Counsel Warren Astleford. You ask whether a taxable use of tangible personal property occurs when extax inventory otherwise used for demonstration and display is transferred into an asset account and is depreciated for income tax purposes. Our response below does not come within the provisions of Revenue and Taxation Code section 6596 since you did not identify the taxpayer and possibly all relevant facts regarding the various transactions.

We previously wrote to your firm on January 27, 1999 (copy attached) regarding a similar issue and concluded, among other things, that the expensing of property held for demonstration and display is a use of property subject to California sales or use tax. You thereafter wrote to the Honorable Dean Andal by letter dated March 15, 1999 (copy attached) disagreeing with our position. On July 13, 1999, then Assistant Chief Counsel Gary Jugum wrote to you (copy attached) reversing our earlier opinion. You now ask whether the current position of the Legal Department regarding this issue is as set forth in our January 27, 1999 letter or that of Mr. Jugum's July 13, 1999 letter to you. With this background, you provide the following:

> "You initially responded to our letter concluding that use tax would apply; however, after additional correspondence,

Mr. Jugum properly concluded that use tax would not apply to the transactions in question.

"The correspondence was written on behalf of a foreign based computer manufacturer (X), headquartered in Japan, who was not paying use tax on the computers (primarily laptops) placed into demonstration service as described.

"We are now writing on behalf of a U.S. based computer manufacturer (Y), headquartered in California, located in another administrative district of the Board. Generally, these are not laptop computers but larger more expensive computers.

"Y is not related to X, but there are remarkable similarities between the two companies as far as using some of the computers they manufacture for demonstration and display. There are also a few distinctions that we believe should not result in a different answer, which we will discuss.

"Y has policies, procedures and controls in place to insure that demonstration/loner equipment is only loaned to qualified customers and qualified potential customers for demonstration and display.

"A computer will be loaned to a qualified customer or qualified potential customer for only one of eleven (11) reasons.

"Some of those reasons include:

> "1. Customer Shows - To promote future sales with a current customer this program allows a loan of a computer to that current customer. The current customer then demonstrates Y's computers internally to other divisions or subsidiaries of the customer.
> "2. Benchmarking - A computer is loaned to qualified potential customers so that those potential customers can compare Y's computer with competitor's computers.

> "Because our question does not relate to these various demonstration and display uses, we will not describe the remaining nine reasons. For purposes of this letter you may assume that the computers were only used for exempt demonstration and display and that Y has evidence to support such exempt use.
>
> "Customers or potential customers must sign a loaner agreement whereby the customer acknowledges the equipment will be used by the customer for internal use only, for a limited time; and that the loaned equipment is offered 'solely for evaluation, demonstration and development purposes.' Depending on the type of computer equipment, the customer or potential customer must return the computer within 45, 60 or 90 days.
>
> "Once Y places computers into demonstration service, they remain exclusively in demonstration service for 18 months until the computers usefulness as a demonstrator has ended. The computer will then be offered for sale. . . .
>
> "At the end of 18 months of use in demonstration service, these computers will necessarily show some signs of use. Additionally, at the end of 18 months, because of the high pace of technical obsolescence in the computer industry, the computers have lost value. Accordingly, pursuant to Generally Accepted Accounting Principles, Y is required to reflect that reduction in value in its books and records.
>
> "Y, therefore, places this demonstration computer equipment into an asset account and takes depreciation expense against that account."

Discussion

Our January 27, 1999 letter to you opined, among other things, that the expensing of extax inventory for income tax purposes constituted a taxable use of property under the Sales and Use Tax Law. We believe that position is correct and further conclude that a taxable use of tangible personal property occurs when extax inventory otherwise used for demonstration and display is transferred into an asset account and is depreciated for income tax purposes.

Mr. Glenn Bystrom July 29, 2002

Internal Revenue Code section 167 (26 USC § 167) authorizes the depreciation of property "used in the trade or business" or "held in the production of income." Pursuant to Treasury Regulations section 1.167(a)-2, the allowance for depreciation does not apply to inventories or stock in trade. Internal Revenue Code section 1231(b)(1) further defines the phrase "property used in the trade or business" to exclude inventory assets. We interpret these provisions to mean that property held as inventory may not be depreciated for income tax purposes.

Inventories are "asset items held for sale in the ordinary course of business or goods that will be used or consumed in the production of goods to be sold." (See Kieso, et al., *Intermediate Accounting*, 10th ed., vol. 1 (2001) p. 394; see also Treas. Regs. § 1.471-1; 2002 *Federal Tax Handbook* (RIA 2001) § 2866.) For financial accounting purposes, inventories are recorded at their original cost. (Kieso, *supra*, at p. 450-451.) Where the value of the inventory declines below original cost for whatever reason (e.g., obsolescence, price-level changes, damage to goods, etc.), the inventory is written down to the lower of cost or market value. (*Id*.) In this context, market value generally means the cost to replace. (*Id*.; ARB No. 43, (AICPA, 1953), Ch. 4, par. 8.) For income tax purposes, the write down in inventory value resulting from the application of lower of cost or market can be taken only in the year in which the actual price decline occurs and must be comprised on an individual item basis, not on the basis of the class of inventory or the inventory as a whole. (Kieso, *supra*, at p. 454; see also Treas. Regs. § 1.471-4.)

In this case, Y proposes to place computer equipment purportedly used for demonstration and display "into an asset account and take[] depreciation expense against that account." We believe that the transfer of property from an inventory to an asset account constitutes a concession that the property is no longer an inventory item held for demonstration and display and instead is a capital asset. The transfer of property between these accounts and the depreciation of this property means that the property will be either "used in the trade or business" or "held in the production of income" within the meaning of Internal Revenue Code section 167. In other words, Y's transfer of its computers from an inventory to an asset account means that Y has now devoted the use of such equipment to its business and is now consuming that property in the course of its business operations. That use is subject to tax. (See also *McConville v. State Bd. of Equalization* (1978) 85 Cal.App.3d 156 [concluding that a taxpayer's capitalization and depreciation of property for state and federal income tax purposes supported a finding that the property was not resale inventory held for demonstration and display but instead was property used as a capital asset and therefore subject to use tax].)

You assert that Y and your firm have "an obligation to insure that assets are not overstated and that expenses are recognized in the period incurred." We agree. To do so, Y may write down its inventory account to the lower of cost or market in order to reflect the reduction in value of its demonstrated computers. Use tax does not apply to that type of write down. However, when Y instead moves its "demonstration" computers to an asset account and necessarily depreciates this account, Y owes use tax measured by its purchase price of these

machines. When Y transfers its "demonstration" computers to an asset account and depreciates this property, it holds this equipment out to the IRS as property used in its trade or business or held in the production of income and not as inventory property. In that regard, we are confident that Y would not take a contrary position with this Agency by asserting that the property it used in its trade or business for income tax purposes was somehow not used in its trade or business for sales and use tax purposes.

Finally, you do not request and nor do we address whether Y's activities involving its computers constitute nontaxable demonstration and display. If you would like an opinion regarding this issue, please write again.

Sincerely,

Janice L. Thurston
Assistant Chief Counsel

JLT: bb
Enclosures: Senior Tax Counsel Warren L. Astleford letter dated January 27, 1999, Honorable Dean Andal letter dated March 15, 1999 and Assistant Chief Counsel Gary J. Jugum letter dated July 13, 1999

cc: Culver City District Administrator (AS)
Mr. Warren Astleford (MIC:82)

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Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

July 13, 1999

Mr. Glenn A. Bystrom
Ernst & Young LLP
725 South Figueroa Street
Los Angeles, CA 90017-5418

Dear Mr. Bystrom:

We have reconsidered our advice to your office of January 27, 1999, in reply to Mr. ----- ' letter to us of December 3, 1998.

It is now our view that the property in question may properly be purchased for resale, and that the contemplated use qualifies as demonstration and display.

Use tax will not apply to the property in question, notwithstanding the fact that the property will be expensed for financial reporting purposes at the time of acquisition. Our initial concern was that for auditing purposes we would not be able to differentiate this property from other property expenses at the time of acquisition. Our understanding is that the property in question will be accounted for separately, thus obviating any practical questions which may have otherwise arisen.

Very truly yours,

Gary J. Jugum
Assistant Chief Counsel

GJJ:sr

cc: Mr. Warren Astleford

ERNST & YOUNG LLP ■ 725 South Figueroa Street Los Angeles, California 90017-5418 ■ Phone: 213 977 3200

March 15, 1999

Honorable Dean F. Andal
450 N Street
Room 2337, MIC:78
Sacramento, CA 95814

Re: Demonstration and Display

Dear Mr. Andal:

As requested, we are forwarding to you 's letter of December 3, 1998 to Mr. Jugum on the above subject and Mr. Astleford's letter in response of January 27, 1999.

In short our client is a manufacturer of computers and a distributor of other office equipment who makes available to potential customers and others inventory items for demonstration and display. Because the majority of the items demonstrated are laptop computers, we will here after refer to these items as laptops.

All of the demonstration and display activities we described in our letter have been ruled by the agency to be exempt demonstration and display and are supported by annotations.

Our client chooses, rather than demonstrating a new laptop only once before offering that laptop for sale, to keep the laptop in demonstration services until it usefulness as a demo has ended before offering that laptop for sale. At all times the laptops are being held for resale, however they will not be sold until their usefulness as a demo has ended. This is done so as to avoid a loss in value, due to demonstration use, to a large number of laptops. Such a practice does not trigger the use tax and is supported by an annotation.

Any use, even an exempt demonstration use, reduces the value of any otherwise unused inventory item. For example the value of a new car decreases by thousands of dollars the minute it is driven off the lot.

Because of the extremely high pace of technical obsolescence in the computer industry, placing a laptop into demonstration service for 6 to 9 months virtually assures that at the end of that time, the laptop will have a significantly reduced value just because of obsolescence. Additionally, at the end of 6 to 9 months of demonstration, the laptop will show signs of use that will further reduce its value.

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Our client, pursuant to generally accepted accounting principals wishes to record that reduction in value in the period it occurs.

We are aware of an annotation that takes the position that the taking of depreciation or charging to an expense account is evidence of use.

Such an annotation, if literally enforced, places our client in the position of either properly recording expenses in the period of use and paying a use tax that would not otherwise be due or not recording the expense in the period so as to avoid use tax. The latter position causes our clients financial statements to be inaccurate.

Prior to sending our December 3, 1998 letter to Mr. Jugum, I discussed this matter with him. Mr. Jugum stated that he believed the Board should change its administrative practice in this area but expressed a desire to limit the change to the high tech area. While I see little difference in the high tech area and other areas, other than the pace by which time and demonstration reduces value, because my client is in the high tech area it resolved my immediate concern.

Unfortunately, our letter was apparently routinely assigned and Mr. Astleford responded. As you can see from Mr. Astleford's letter, he did not question any of the described uses as being outside of exempt demonstration and display. Rather Mr. Astleford concluded that the accounting treatment of expensing an item or taking depreciation for income tax purposes is to be considered a use, subjecting the property to use tax. Upon receiving Mr. Astleford's letter I discussed the matter with Mr. Jugum who stated that because the letter has now been issued, he did not wish to take the steps necessary to change the policy.

I then faxed the letters to Mr. Speed and discussed the issue with him. Mr. Speed appeared to agree that the use tax should not be due under the facts described but wanted to discuss the matter with Mr. Jugum. Mr. Speed then called me in a few days and stated that the Board did not wish to change its administrative policy is this area.

We believe it is time for the Board to change its administrative policy in this area and allow taxpayers to recognize economic reality.

Mr. Astleford states that the charging of the computers to an expense account is for "anticipated losses" and is not allowable for income tax purposes. These are not "anticipated losses" when a brand new lap top is removed from it's box and sent out for just a one week demo to 50 different people in a single company it is a used computer with a significantly lower value when it comes back. It makes financial sense, when that computer comes back, to keep it in demonstration service until its usefulness as a demo has ended rather then sell it and then place another new computer into demonstration service. Such a practice does not trigger a use tax (annotation 210.0160).

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We agree that the recording of an item to either a capital asset account or an expense account is a presumption, (perhaps strong) that a use has been made.

However, at a minimum, we believe it should be a rebuttal presumption. If, as in the case here, a taxpayer maintains records showing that the item were in fact used for exempt demonstration and display purposes we believe that we have overcome the presumption.

The annotations cited by Mr. Astleford, 570.0150 and 495.0240 are not on point to the fact pattern presented here. Mr. Astleford misunderstood on position on annotation 210.0116. We were, it seem correctly, concerned that annotation 210.0116 would be used to tax tangible personal property either capitalized or charged to an expense account, irrespective of the evidence the taxpayer maintained showing that no use other than exempt demonstration and display was made.

While we are confident that our position would prevail if the issue was pursued through the appeals process, our client is not under audit, and does not wish to volunteer for an audit. Additionally the appeals process is both expensive and takes far too long to complete.

In our view the annotations in this area are incomplete and should either be expanded or a new annotation should be added. For these reasons we are hopeful that your office will forward this letter and its attachments to Mr. Jugum and Mr. Speed requesting that they reconsider their position.

We would be delighted to work with your office, Mr. Jugum and Mr. Speed to provide any additional information needed.

Very truly yours.

Glenn Bystrom

Principal

Attachments

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E. L. SORENSEN, JR.
Executive Director

January 27, 1999

Ernst & Young LLP
515 South Flower Street
Los Angeles, California 90071

Re: Unidentified Taxpayer;
Demonstration and Display

Dear Mr. ---:

This is in response to your December 3, 1998 letter to Assistant Chief Counsel Gary Jugum regarding the application of tax to your client's operations. Our response does not come within the provisions of Revenue and Taxation Code section 6596 since you failed to identify the taxpayer and possibly all relevant facts regarding the various transactions.

You state:

> "Our client (X) is a manufacturer of computers and a distributor [of] other electronic office equipment. The vast majority of X's sales are for resale to authorized resellers of such equipment.
>
> "X makes available to its customers, and others, both within California and outside of California, inventory items, through a third party, for the following types of . . . uses:
>
> 1. X's salespersons will circulate new computers (while X also make[s] available the office equipment it distributes, because the vast majority of the equipment

that is the subject of this letter are personal computers, we have used the term 'computer') to their customers for the purpose of demonstrating and displaying that computer to the salesperson's customers, all of whom are resellers. Because some of the customers have a large sales staff the computer might remain at a particular customers place of business for a period of time (usually one to three months.).

2. Some of X's customers (volume resellers) sell computers to large corporate users of its computers who might purchase hundreds or thousands of computers for their own use. Even though X does not sell directly to these corporate users, because of the volume of sales to these corporate users, X's sales staff has contact with the customers. Either the volume reseller or X's sales staff will request that a new computer model be sent to these large corporate users for their evaluation. Because of the size of these customers, the computers may be evaluated by a number of personnel or departments and remain with the corporate users for a period of time.

3. New computer models are sent to influential publications or journalists for evaluation.

4. New computer models are placed in a 'demo' pool to be circulated to the dealer channels.

5. New computer models are used to train X's sales personnel in the use and operation of the computer.

6. Distributors who purchase for resale a very large volume of computers, will receive, at no additional charge, a small quantity of additional similar computers. This enables the distributor, for example, to immediately replace any defective computers that have been sold to its customers. To the extent these additional computers are not required for that purpose, the distributor may also resell these computers either to second line distributors for resale or to consumers.

"To manage the computers used in the above described demonstration activities, or other uses, and to insure that the computers are used only for authorized purposes, X utilizes a third party (Y). Initially a quantity of the new computers required for anticipated demonstration needs are sent to Y by the various marketing and sales departments of X. This is done to identify costs by department.

"Because the computers described in activities one to five above, are expected to be returned, Y employs the following procedures:

"When Y receives the new computers, it inventories the computers by type of computer only (product model) and the department of X that sent the computer. These computers are identified as 'new'. Computers previously demonstrated, returned and completely refurbished by Y are identified as 'complete'.

"Y's inventory listing of computers is on line to the various marketing and sales departments of X.

"A marketing or sales manager of X, after determining that the desired computer is available, will instruct Y to ship the computer. The following information is provided to Y: The request date; the name of the requester; shipping address; shipping method; purpose (demo, sample evaluation, etc.); type of computer; quantity; and return date.

"Y will then select the best available computer, install and test any requested accessories, and ship the computer and change the inventory status from 'new' or 'complete' to 'field'. Y also records the computer's serial number to insure that the exact same computer is returned by the customer. However computers can only be tracked and inventoried by product model in Y's records. X's records reflect only the dollar value of computers at Y or returned by Y to X.

"At the end of the demonstration period (typically from 30 to 90 days) X's manager contacts the customer to secure the return of the computer.

"When the computer has been returned, Y changes the inventory status to 'needs test' until the computer is tested and rebuilt by Y, at which time the inventory status is then changed to 'complete' or, on occasion 'broke'. The 'complete' computer is then available for demonstration to another customer. Periodically Y will take a physical inventory, and

despite the excellent internal controls some inventory shrinkage is discovered.

"On occasion a customer is unable to return the computer because it has been lost or stolen. X's manager discusses the financial responsibility with the customer. Ordinarily the customer has insurance coverage and assumes financial responsibility. Occasionally the customer resists filing an insurance claim or states that it has no insurance for the type of loss. X then makes a business decision as to whether the customer should be billed. Some customers are not billed because it would damage the business relationship. Y is informed of all losses and instructed to either bill or not bill the customer. The computers are removed from the inventory list.

"Periodically, as computers become obsolete or broken beyond repair, Y will return these computers to X. These computers will then be sold, sometimes as scrap, by X.

"With respect to the computers described in six above, Y ships these computers to the distributors as directed. These computers are not returned they are provided to the distributors as additional products at no charge in consideration for purchasing a large volume of computers.

"In addition to the above exempt uses of inventory items, X, without using Y, also places inventory items directly into the following types of . . . uses:

7. New computer models are sent to manufacturers of accessories, other products and software products which need to interact with X's computers. X's new computer models and the manufacturer's products are tested to determine if the products will function with each other as part of an equipment system. The manufacturers return these computers when compatibility testing is completed.

8. Pre production testing. Generally prior to a full production run, a short production run of 10 to 15 computers is made. These computers are tested to validate production techniques, configuration, packing, fit and finish. After the engineering department, the

marketing department, the support department agree the computers meet with their acceptance, full production starts.

9. New computer models are used to familiarize service personnel in the use and operation of the computer in a service class conducted by X. As part of the familiarization process the computers are taken apart. The services personnel are employees of authorized services providers. All services personnel of these authorized services providers are required to take repair courses provided by third party providers and be certified in computer repair before becoming eligible to attend the service class offered by X. The purpose of the class is not to train the services personnel in actual computer repair, as all attendees are fully trained, but rather to familiarize the services personnel with the latest models so that the first time the service personnel see the latest model it will not be when a customer brings the computer in for repair.

"After the above three uses the computers are sold by X, sometimes as scrap.

"[T]he computers are not offered for sale until their usefulness in the above described activities has ended. . . . At times it will cost more to restore a computer to a marketable condition than the value of the computer. In those cases the computers may be sold as scrap. When the computers or components have no value as scrap, they, of course, cannot be sold and are simply destroyed.

"Finally, because of the rapid obsolescence and continual price reductions in the computer industry, and to ensure that X's books reflect generally accepted accounting principals, the proper accounting treatment is to charge the cost to an expense account when computers in inventory are placed into the above uses. If the computers are sold, these sales should be recorded as miscellaneous income or as a credit to the expense account."

You ask whether the foregoing activities qualify as nontaxable demonstration or display.

Discussion

A person who gives a resale certificate to purchase tangible personal property for use solely for demonstration or display while holding it for sale in the regular course of business is not required to pay tax on account of such use. (Reg. 1669(a).) If the property is used for any purpose other than or in addition to demonstration and display, the purchaser must include in the measure of tax reported the purchase price of the property. (*Id*.)

Depreciation and "expenses" are income tax principles. Depreciation provides for the reasonable reduction in basis of property used for the production of income. (See IRC § 167; Rev. & Tax. Code § 17250, 24349.) Expenses generally include any allowed deductions against taxable income. (See IRC § 161; Rev. & Tax. Code §17201.) The application of either of these principles creates an income tax benefit to a taxpayer. This Agency has consistently looked to a taxpayer's depreciation of assets to show that those assets are not held for resale (see, e.g., BTLG Annot. 570.0150 (9/19/94)), or as evidence of an exercise of ownership (see, e.g., BTLG Annot. 495.0240 (3/17/70)). This treatment is consistent with the Third District Court of Appeal's decision in *McConville v. State Board of Equalization* (1978) 85 Cal.App.3d 156 which found, among other things, that the depreciation of a capital asset is a use of tangible personal property for sales and use tax purposes. In that regard, we consider "expensed" tangible personal property deducted against a taxpayer's income the same as depreciated tangible personal property in terms of: 1) being used by the taxpayer for sales and use tax purposes; 2) not being held for resale in the ordinary course of business; and, 3) evidence of ownership of the property by the taxpayer.

We understand that the cost of the computers in question is charged to an expense account of X. That is, X will deduct for income tax purposes its anticipated losses from the reduction in value of the computers it purports to hold in its resale inventory. We believe that anticipated losses in the value of inventory are not deductible for income tax purposes. (See, e.g., 2 Mertens Law of Fed. Income Tax §16.20.) Where X expenses its computers offered to potential customers, service personnel, manufacturer's of related accessories, journalists, etc., we regard such income tax treatment as a use of the computers for sales and use tax purposes. In other words, the expensing of extax property for income tax purposes is a use of that property for sales and use tax purposes. X's expensing of these computers is inconsistent with its purported attempts to hold these computers for resale and constitutes a use of the property. The fact that X may (or may not) partially credit its expense account if the computers are ultimately sold at retail does not alter our conclusion.

We disagree with your position that Annotation 210.0116 (1/5/94) allows X to expense its computers while holding them for resale. That annotation generally addresses situations where depreciation is claimed *in error* by a taxpayer, there is no tax advantage to the taxpayer from its erroneous actions, and the taxpayer made no taxable use of the property. We understand

that X seeks our opinion with respect to its prospective operations. Since we are of the opinion that X may not expense its computers and hold them for resale, X may not subsequently do both and contend they expensed their computers in error. We further assume that X will receive a tax benefit from its expensing of its computers thereby further removing it from the provisions of Annotation 210.0116.

We do not address your other contentions as to whether X's various distributions of its computers (through Y or otherwise) to others constitute nontaxable demonstration or display. We further express no opinion as to whether X's activities in situations one through nine are demonstration or display beyond our position that X's expensing of these computers is a taxable use. If X decides to revise its operations and not expense its computers, you should write again. If you do, please provide us with a full factual background, copies of all relevant contracts and documentation, and the name of the taxpayer so we can appropriately respond. You should disclose all this information in a single letter to us in order to minimize the time and resources necessary for us to answer questions like this.

Sincerely,

Warren L. Astleford
Senior Tax Counsel

WLA:cl

cc: Industry District Administrator (AP)